No. 21,184

IN THE

United States Court of Appeals

For the Ninth Circuit

In the Matter of
FIKE PLUMBING & HEATING CO., INC.,
Bankrupt.

TUCSON HOUSE CONSTRUCTION COMPANY AND
ROBERT E. MCKEE GENERAL CONTRACTOR, INC.,
Appellants,

vs.

WALTER E. FULFORD, as Trustee in Bankruptcy of
FIKE PLUMBING & HEATING CO., INC.,
Appellee.

On Appeal from the United States District Court for the District of Arizona

BRIEF OF APPELLEE

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BRIEF OF APPELLEE

A STATEMENT OF THE CASE

This action was initiated by appellee in an effort to effect collection from the General Contractor of the sum of $59,587.45 in retention funds which the latter, after having collected same from the Owner, chose to convert to a use other than paying the bankrupt plumbing subcontractor.

Ironically, appellee has been and still is resisted by a surety company—through *its own* attorneys and *at its own expense*—who had absolutely nothing to do with the contract or the job giving rise to these retention proceeds. (T. I, 24-27; Trustee's Exhibit 10.)

The salient facts of this case, when viewed in proper perspective, are as follows:

On July 5, 1962, Tucson House Construction Company, comprised of Bernard W. Robbins, Raymond S. Schiff, and Robert E. McKee General Contractor, Inc., a Nevada corporation, were awarded a cost-plus F.H.A. Construction Contract with a guaranteed handsome profit of $557,556.00. (Trustee's Exhibit 1.) The Owner designated therein is Tucson Title Insurance Company, as Trustee under Trust No. 10578. The owners of the beneficial interest in said trust, as best as can be ascertained from the record, are Bernard W. Robbins, Raymond S. Schiff, and Seymour W. Schiff. (Trustee's Exhibit 2.)

The Construction Contract provides, among many other things, that the General Contractor, Tucson House Construction Company, had agreed "not to assign this Contract or any amount payable [t]hereunder or to sublet the whole or substantially the whole of this Contract . . ." It also provides for a 10% retention by the owner.

Several days prior, on July 2, 1962, McKee, Robbins, and Raymond S. Schiff entered into an agreement entitled "Joint Venture Agreement" for the specific purpose of forming "a joint venture which, as general contractor" would enter into the Construction

Contract previously described. (Trustee's Exhibit 2.) The rights, the responsibilities, and the duties of the co-adventurers are fully spelled out therein. Furthermore, it is said to contain all the terms and conditions of the joint venture. (T. I, 5-6.)

Seymour W. Schiff, one of the beneficial owners, was not a party to the joint venture.

A month or so later, on August 6, 1962, Tucson House Construction Company, as the General Contractor, awarded the plumbing Subcontract to Fike Plumbing & Heating Co., Inc., bankrupt (Trustee's Exhibit 3.)[1] The Subcontract provides, among other things, that the 10% retention proceeds would be due and payable to the Subcontractor "30 days after completion and acceptance of subcontractor's work by the owners and receipt of final payment from the owners." It also provides in Paragraph 29 thereof for attorney's fees to the prevailing party, in the event of litigation.

As a condition of the Subcontract, Fike was required, and did in fact, post a performance and payment bond running to the General Contractor. The bond was written by National Surety Corporation. (Trustee's Exhibit 4.)

By appellants' own admission, Fike had completed its work in January or February of 1964 (T. I, 64), and the beneficial owners, in the words of Mr. Haug, "actually moved in and had occupancy of the building

[1] Although the Subcontract is on a McKee form, it is admitted that it was between Tucson House Construction Company and the bankrupt. See, Appellants' Opening Brief, p. 3.

in February, 1964." (Trustee's Exhibit 14, Answer to Trustee's Interrogatory No. 13.) According to the same Answer, the F.H.A. had accepted the project as 100% complete on June 22, 1964.

During the course of Fike's work, all progress billings were submitted to Tucson House Construction Company and were paid by *it,* on *its own* checks, drawn on *its own* bank accounts. (T. I, 20-21.)

In August of 1964, not having received its retention proceeds, Fike filed with the Pima County Recorder's office a Notice and Claim of Lien in the form prescribed by Arizona statutes. (Trustee's Exhibit 6.) Through inadvertence or neglect, a copy of the Notice and Claim was never formally served upon the Owner, namely, Tucson Title Insurance Company, as Trustee.

The Notice and Claim was filed at the request of McKee, and its existence—having been made a matter of record—became known to McKee and the Owner in the early part of December, 1964 (T. I, 122), before the final settlement day. As a condition of releasing the final payment, the Owner required and obtained from the General Contractor a Lien Release Bond. (Respondents' Exhibit 12.)

In June of 1963 the bankrupt was awarded by McKee, in its individual capacity and as General Contractor, the plumbing Subcontract on the John C. Lincoln Hospital Job. (Respondents' Exhibit 8.) As a condition of receiving this Subcontract, Fike was required to post a performance and payment bond running, of course, to McKee as the General Contractor. The bond was posted. The surety on this bond was Standard

Accident Insurance Company, which has since merged with Reliance Insurance Company. (Trustee's Exhibit 5.)

On November 17, 1964—the very day that Fike was adjudged a bankrupt—Mr. Dale of McKee wrote Fike a registered letter from El Paso, Texas, in regard to the Lincoln Hospital Job, advising the latter that McKee had elected to declare Fike "in default and to call upon [its] bonding company to complete this work and see that all bills are paid." (Trustee's Exhibit 7.) The letter was received on November 19, 1964. (T. I, 6.) The bonding company—Reliance Insurance Company—immediately took over and thereafter completed Fike's job. (Trustee's Exhibit 14; Answer to Trustee's Interrogatory No. 30.)

At the time of Fike's bankruptcy, on November 17, 1964, Fike ostensibly owed $50,745.12 to its suppliers on the Lincoln Hospital Job. (T. I, 117.)

On December 5, 1964, Mr. Dale, writing *for* Tucson House Construction Company, advised National Surety Corporation, Fike's surety on the Tucson House Job, that he had decided to retain Fike's retention proceeds for the life of the one-year warranty, which he calculated would commence on December 10, 1964, and to pay off certain unpaid suppliers of Fike who had furnished labor or supplies to Fike on the Tucson House Job (Trustee's Exhibit 8). (Interestingly, not a word was said by Mr. Dale in regard to using these proceeds for any setoffs.)

On January 22, 1965, the bankruptcy trustee made a demand upon Tucson House Construction Company

—although the letter was simply addressed to McKee, because it was the managing co-adventurer—for the immediate release or payment of the Tucson House Job retention proceeds "less any credits for [its] payment of any material suppliers who had valid claims for materials furnished on the subject job. (Trustee's Exhibit 9.)

On February 10, 1965—almost three months after Fike's bankruptcy—McKee and Reliance, with the consent of National Surety Corporation, reached an accord whereby McKee agreed to use Fike's retention proceeds on the Tucson House Job for the payment of the suppliers on the Lincoln Hospital Job, with the proviso that Reliance would "protect, indemnify and hold harmless McKee . . . from and against all loss, damage and expense (including attorneys' fees)" on account of any claim made against it by anyone *and specifically the bankruptcy trustee.* Furthermore, Reliance agreed to defend such an action in the name of McKee, or otherwise, "but at the sole cost and expense of Reliance." (Trustee's Exhibit 10.) The entire scheme was predicated, in the words of Mr. Haug—the admitted author of this Exhibit, prepared by him while representing both McKee and Reliance (T. I, 24) and being a member of the creditors' committee in the bankruptcy proceedings (Referee's Finding of Fact 19)—upon this basis, to wit:

> ". . . Reliance claims this right to require this offset by virtue of its right of subrogation to the rights of McKee arising out of the relation of principal and surety under law and equity." (Trustee's Exhibit 10.)

On February 19, 1965, Tucson House Construction Company promptly transferred $50,745.12 of Fike's retention proceeds to McKee, and McKee—armed with the indemnity by Reliance—disbursed same among Fike's suppliers on the Lincoln Hospital Job.

Even before the transfer, on February 16, 1965, Mr. Dale, in a letter to counsel for appellee, opined, unequivocally:

> ". . . There will therefore be no proceeds remaining on the Tucson House which will be available to the bankruptcy court." (Trustee's Exhibit 17.)

On March 15, 1965, the trustee, while still somewhat in the dark as to the precise details, filed his Petition for a Turnover Order, and on September 8, 1965, he amended same in line with the products of his investigation.

The Bankruptcy Referee, sitting as a trial Court, and the District Court, sitting as a reviewing Court, have both concluded that the bankruptcy trustee is entitled to the retention proceeds on the Tucson House Job, i.e., the sum of $59,587.45, less $2,765.45 which was paid to Fike's suppliers on the Tucson job and $1,375.87 which was expended by Tucson House Construction Company on warranty items.

Moreover, the trustee was also awarded interest and attorney's fees.

Hence this appeal.

A SUMMARY OF THE ARGUMENT

I. The trustee maintained below, and still maintains, that the attempted setoff by McKee, though ingenious it may be, is not permissible under Section 68 of the Bankruptcy Act (11 U.S.C., §108), for want of "mutual debts". The requisite mutuality is lacking for all or either of these reasons:

A. Fike owed nothing to McKee at the time of its bankruptcy. Fike's obligation stemming from the unpaid bills on the Lincoln Hospital Job was first and formost *its* obligation. It, and it alone, was *the primary debtor.* Any secondary debtor, be it McKee or Reliance, could only be subrogated to the rights of the suppliers whose claims it paid. These suppliers, i.e., creditors, admittedly had no right of setoff against Fike.

B. The debt owing from Tucson House Construction Company, a joint venture, to Fike, and the debt owing by Fike to McKee individually, if any, by reason of the unpaid bills on the Lincoln Hospital Job, are not *owned* and *owed* in the same right by the same parties in the same capacity.

C. The retention proceeds here in issue were in the nature of trust funds, and moreover, were wrongfully obtained by McKee from Tucson House Construction Company, even if the latter received same rightfully from the Owner after Fike's bankruptcy.

II. McKee itself had no right to effect a setoff in the manner attempted by it; consequently, Reliance Insurance Company, as subrogee to the rights of McKee, could not have compelled McKee to do what

it itself had no right to do. It is the settled law that one cannot acquire by subrogation what another, whose rights he claims, did not have.

Moreover, it is also settled that a surety is subrogated only to those rights of the obligee against the principal which stem from the contract for which the surety is bound. In other words, the rights of an obligee (McKee) against a principal (Fike) which stem from matters unrelated to the contract for which the surety is bound do not inure to the benefit of the surety (Reliance). Here the Tucson House Job was wholly unrelated to the Lincoln Hospital Job. It, therefore, follows that Reliance, as surety on the Lincoln Hospital Job, can't avail itself of any benefits that McKee might have had in the retention proceeds under the Tucson House Job.

Last but not least, A.R.S. §12-1641, granting a surety the right to require an obligee "to bring an action upon the contract" against the principal, if the obligee is not "under legal disability" to do so, has no application to the case at bar, and even if it does, it has not been complied with.

III. An award of interest on a liquidated debt is a proper item of damages, and an award of a reasonable attorney's fee, when so provided for by contract, is a proper item of costs.

ARGUMENT

I. THE ATTEMPTED SETOFF IS INVALID FOR ALL OR EITHER OF THESE REASONS:

A. Fike Owed McKee No Debt.

Appellants readily admit that "one of the things they must show is that Fike owed a debt to McKee." That is, of course, true, but in order to prevail they must also show that the debt, if any, was owed by Fike to McKee *at the time of its bankruptcy,* for "the rights of parties under §68 are adjusted as of the date of bankruptcy." 4 *Collier, Bankruptcy* (14th Ed.), §68.10[1], page 754; *Prudential Insurance Co. of America v. Nelson* (1939), 6 Cir., 101 F.2d 441, cert. den. 308 U.S. 583, 60 S.Ct. 106, 84 L.Ed. 489.

The trustee submits that appellants failed in their proof and the burden is clearly theirs. 4 *Collier, Bankruptcy* (14th Ed.), §68.10[2], page 759.

When Fike received formal notice of its default several days after its bankruptcy, it owed $50,745.12 to its suppliers on the Lincoln Hospital Job. Because these debts were incurred by Fike, they were naturally first and foremost *its debts.* Fike, and Fike alone, was *contractually*—in the classical privity of contract sense—bound to pay them. In brief, Fike was the *primary debtor.*

Upon Fike's default the responsibility for paying these debts and to complete Fike's plumbing Subcontract devolved upon Reliance Insurance Company. This was clearly the nature of Reliance's undertaking under its performance and payment bond, of which McKee was the obligee. *American Casualty Co. v.*

Town of Shattuck, Okla. (1964), 228 F.Supp. 834, 838 (W.D. Okla.). Thus, Reliance became the *secondary debtor*.

In fact, upon Fike's default and failure to pay these obligations, Reliance was subject to a direct suit by these suppliers as third party beneficiaries under its bond, i.e., its surety contract with McKee. *Griffith v. Stucker* (1913), 91 Kan. 47, 136 P. 937, 939.[2] *Pacific States Electric Co. v. United States F & G Co.* (1930), 109 Cal.App. 691, 293 P. 812, 813.[3]

Now, as between McKee and these suppliers there was obviously no privity of contract, thus, McKee was not personally responsible for the payment of these debts. In Arizona an owner is not *personally* responsible for the payment of his contractor's debts incurred during the course of construction unless the contractor was his "agent" in the classical sense of the term. *Keefer v. Lavender* (1952), 74 Ariz. 24, 243

[2]"These claims were debts of Lightfoot Bros. [the subcontractor] and not of Stucker [the general contractor]. They were primarily liable to their own laborers and materialmen. Stucker was in effect only a surety of his subcontractor, and the very purpose and object of the bond was to secure payment by Lightfoot Bros. of their own debts, a matter of direct and special importance to those to whom they were indebted. This being true . . . establishes the right of the laborers and materialmen employed by Lightfoot Bros. to adopt the bond and enforce it by action brought directly against the surety company which signed it."

[3]"The obligation of the respondent [as surety of the subcontractor] in the present cases to guarantee payment for labor performed and materials furnished under the subcontract seems fixed and certain. *The fact that these claimants may have been entitled to recover compensation from the original general surety, Metropolitan Casualty Insurance Company, does not release the respondent from the clear obligations of its contract* . . ." (Emphasis supplied.)

P.2d 457. The same case further holds that the mere relationship of owner and general contractor does not in and of itself raise such an agency relationship. The same reasoning equally applies to the relationship of general contractor and subcontractor, i.e., the latter is not the former's agent by virtue of this relationship alone. Since Fike was obviously not McKee's agent, it could not have bound McKee for the payment of these debts.

It is true, of course, that McKee was responsible under its contract with the Owner to deliver the subject job free and clear of all claims and liens. This undertaking, however, bound it *only to the Owner* and certainly not to the suppliers of Fike. The provisions of its contract ran to the Owner, and they did not inure to the benefit of Fike's suppliers for obvious lack of privity of contract. It is also true that McKee, with General Insurance Company of America as its surety, posted a performance and payment bond running to the Owner, but this undertaking, insofar as it pertains to Fike's subcontract and its suppliers thereunder, was merely in the nature of being a surety for a surety, i.e., it would have become operative only upon the refusal or inability of the underlying surety, namely, Reliance Insurance Company, to perform its undertaking. Cf. *Griffith v. Stucker,* supra. Even if it be assumed that a direct action might have been brought against McKee under this bond—there is, of course, no evidence in this record to show that Fike's suppliers ever made a demand upon McKee or that they complied or could have complied with the terms

and conditions thereof—McKee would have had a right to cross-claim against Reliance. *Pacific States Electric Co. v. United States F & G Co.*, supra.[4] In fact, as is suggested in the latter case, in order to avoid a circuity of actions, it is by far the better practice to require the suppliers of the subcontractor to sue the surety of the subcontractor, even if they could have sued the surety of the general contractor in the first instance.

Thus, McKee was at best but third in line as to responsibility for paying these obligations. Because of Reliance's clear duty and ability to respond, McKee's contingent liability never came into existence. Its paying of these obligations—in *form* but certainly *not* in *substance*—almost three months after Fike's bankruptcy could not place it into the position of a *creditor* of the bankrupt as of the date of its bankruptcy.

Absent a debt due McKee from Fike, i.e., it being a creditor of Fike as of the date of its bankruptcy, there is nothing against which it could effect a setoff under §68 of the Act.

Even if it be assumed, for the sake of argument, that McKee was obligated to pay these suppliers because of Fike's insolvency and that it did in fact do so, its claimed right of setoff must fail nevertheless

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[4]". . . In the event of securing judgments against the original general surety by the claimants in this action, it would then be entitled to be subrogated to all the rights of these plaintiffs for the purpose of reimbursement, which would include the right to resort to respondent's bond [the surety for the subcontractor] to satisfy their claims."

by virtue of Section 57(i) of the Bankruptcy Act, which is to the effect that a secondary debtor—it will be remembered that McKee is not a primary debtor—is subrogated, as a matter of law, to the rights of the creditor of the primary debtor whose obligation he paid.

To be more specific, §57(i) (11 U.S.C., §93) provides in pertinent part as follows:

> "Whenever a creditor whose claim against a bankrupt estate is secured, in whole or in part, by the individual undertaking of a person, fails to prove and file that claim, that person [the surety] may do so in the creditor's name, and he [the surety] shall be subrogated to the rights of the creditor, whether the claim has been filed by the creditor or by him in the creditor's name, to the extent that he discharges the undertaking . . ."

An excellent dissertation on the meaning and effect of §57(i) is found in *Phoenix Indemnity Co. v. Earle* (1955), 9 Cir., 218 F.2d 645, 650. There this Court quoted and approved this language, now found in 3 *Collier, Bankruptcy* (14th Ed.), §57.21, pp. 335-336, to wit:

> "The surety normally has against the principal a claim, express or implied, absolute or contingent, to be indemnified or reimbursed. Without §57i there could be no doubt but that such a claim is provable by the surety in the same manner any other claim provable under §63a [11 U.S.C.A., §103, sub. a] may be presented, namely as the surety's own claim against the bankrupt principal debtor. Section 57i flatly *denies* this right. It confines the secondary debtor to a proof

of the *creditor's* claim, in the *creditor's name*. 'A creditor may indeed prove against both principal and surety, but that is because he has two separate claims, really he has security upon a single claim. But there can never be more than one claim against the principal.' It is this *one* claim, namely the creditor's claim, that the surety may prove prior to or after subrogation, and not his own claim upon an agreement, express or implied, of indemnity."

Admittedly, the suppliers to whose rights McKee or Reliance could be subrogated have no right of set-off against Fike. There exists, of course, no "mutual debts" between these suppliers and Fike. Consequently, McKee or Reliance as successor to their interests can likewise have no right of setoff against Fike. In fact, to be technical, McKee is not entitled to any subrogation whatsoever, for, as is said in *Simpson on Suretyship*, §47, page 209:

> "A volunteer who pays, not being legally or morally obligated to do so, is not entitled to subrogation."

B. A Debt Due a Bankrupt From a Partnership Cannot Be Set Off Against a Debt Due by the Bankrupt to an Individual Partner.

The Joint Venture Agreement, the sole and certainly the best evidence with respect to the formation of Tucson House Construction Company, clearly shows that the parties thereto intended to, and did in fact, create a valid joint venture. The argument that Tucson House Construction Company was McKee, and vice versa, i.e., that the former was but a front

and subterfuge for the latter, borders on the criminal, for this is not the picture that was represented to the F.H.A.[5] Cf., 18 U.S.C.A., §1010. It is, however, of no avail herein to McKee, for all the elements of a joint venture can readily be found within the confines of the Joint Venture Agreement itself. The joint venture was obviously created via a contract, by people who have pooled their skills, efforts and resources, with a common purpose of obtaining a lucrative construction contract, to own it jointly, and to perform it successfully with a view of apportioning the profits—and possibly the losses—between themselves. The fact that the profits and losses of the joint venture were not to be, necessarily, borne equally and that two of the co-adventurers relinquished a good deal of the control to McKee, who undertook to act at all times "in behalf of the joint venture" does not alter the legal efficacy of the joint venture. 30 *Am. Jur.*, Joint Adventures, §§6 through 11, and §40.

Moreover, it is immaterial whether McKee believes that a joint venture did or did not exist, for, as to third parties, "the relation will be determined from the facts rather than the conclusions of the co-partners . . ." *Mercer v. Vinson* (1959), 85 Ariz. 280, 287, 336 P.2d 854.

It is the settled law that an essential element of mutuality under Section 68(a) of the Bankruptcy Act, 11 U.S.C. §108, is that "the debts or credits must be in the same right and between the same parties, standing in the same capacity." 4 *Collier, Bankruptcy,*

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[5]See, Construction Contract, Trustee's Exhibit 1.

§68.04[2.1]; *Lyders v. Petersen* (1937), 9 Cir. 88 F.2d 9. Cf. *In re Berger Steel Co.* (1964), 7 Cir., 327 F.2d 401. It is, therefore, also the settled law that a debt due a bankrupt from a solvent partnership may not be set off against a debt due from the bankrupt to an individual member of such partnership. 4 *Collier, Bankruptcy,* §68.04[2.2]; *In re Shults* (1904), 132 F. 573 (D.C. N.Y.); *In re T. M. Lesher & Son* (1910), 176 F. 650 (D.C. Pa.); *In re Bank of Sampson* (1934), 205 N.C. 333, 171 S.E. 436. This is true even if such a partner were severally responsible for the payment of the obligation of the partnership. *Poncet Davis Co. v. Roberts* (1943), 5 Cir., 138 F.2d 538. In fact, appellee is unaware of a single bankruptcy case wherein a partnership debt was permitted to be set off against an individual debt, and vice versa. If appellants know of one, they have never cited it.

There is, indeed, a good reason for this rule, it being that a partnership debt is first and foremost the responsibility of the partnership. The liability of a co-partner becomes his several obligation only when the partnership property is inadequate to pay the partnership debts or when there is no effective remedy without resort to his individual property. *Friedman v. Gettner* (1948), 180 N.Y.S.2d 446, aff. 163 N.E.2d 141. Arizona law is clearly to the same effect, *Springer v. Bank of Douglas* (1957), 82 Ariz. 329, 313 P.2d 399.

The fact that in *Springer* there was a mortgage to secure the partnership obligation represented by a note does not alter the proposition that partnership debts should be first paid out of partnership assets,

for in Arizona one may sue upon a promissory note secured by a mortgage without resort to the mortgaged security. In other words, foreclosure of a mortgage is a separate equitable remedy which one may or may not invoke in a suit for the collection of the debt represented by the note. *Smith v. Mangels* (1952), 73 Ariz. 203, 240 P.2d 168.

Moreover, if there were a choice as to whether a creditor may sue the partnership or one of its partners individually, logic dictates that the choice would lie with the creditor. Here the trustee, as a creditor of Tucson House Construction Company, elected to sue the joint venture for the retention proceeds, and it is certainly not within McKee's province to compel him to sue it individually.[6]

The case of *In re Sherman Plastering Corporation* (1965), 2 Cir., 346 F.2d 492, so heavily relied upon by appellants, is readily distinguishable from the case at bar. In fact, but for some superficial resemblance, it is not even analogous to the case at bar. There Hanover *owned* its claim against the bankrupt in its own right, and it proved same in its own name and in its own right, as it had a right to do.[7] Here McKee did not own a claim against Fike at the time of the bankruptcy; thus, if McKee had filed a Proof of Claim in the bankruptcy proceedings based upon its post-bank-

[6]McKee is named individually as one of the respondents, but this stems from its conversion of $50,745.12 from Tucson House Construction Company.

[7]"A surety who has satisfied the creditor prior to the filing date in his principal's bankruptcy therefore proves his own claim, not that of the original creditor, and Section 57i does not apply." 3 *Collier, Bankruptcy*, §57.21[2], page 338.

ruptcy payment of Fike's suppliers on the Lincoln Hospital job—which it did not—by virtue of 57(i), such a claim would have had to be *not* in its own name and *not* in its own right, but that of a subrogee.[8] In *Sherman* the claim owed by Hanover to the bankrupt was its own debt, i.e., its own obligation with the sole exception that it stemmed from a co-surety relationship. But even as a co-surety, it was specifically bound by the terms of the jointly executed bond "severally". Here the debt is not owed by McKee but by a solvent partnership of which it is but one of the members. In *Sherman,* because the joint obligation did not stem from a partnership obligation, the Court did not concern itself with partnership law. This is clearly pointed out in the Court's decision by this language, found on page 495:

> "Viewed in one light, Neaderthal deals with the problem of a set-off *in the context of law of partnership, not at all involved in our case.*" (Emphasis supplied.)

Moreover, there the Court could rightfully say, and did in fact say, on page 493, that the debts were "owed [Hanover] and owned by the same party [Hanover] acting in the same capacity." This is obviously lacking herein.

Last but certainly not least, *Sherman* does not state the proposition that a joint debt, and particularly a partnership debt, can always be set off against a sepa-

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[8]"If the surety discharges the debt after commencement of the bankruptcy proceedings against his principal, §57i applies" 3 *Collier, Bankruptcy,* §57.21[2], page 339.

rate debt, and vice versa. It merely states an exception to the rule.

It is hard to conceive how the debt sought to be set off herein—which is not owned by McKee in its own right, to begin with—even approaches mutuality with that owed Fike by Tucson House Construction Company.

C. There Can Be No Set-Off Against Trust Funds or Wrongfully Obtained Proceeds.

It is settled beyond doubt that there can be no set-off against trust funds or wrongfully obtained proceeds. *Morris v. Windsor Trust Co.* (1914), 213 N.Y. 27, 106 N.E. 753, 754;[9] *Emerson v. Fisher* (1918), 1 Cir., 246 F. 642, 649; *Irving Trust Company v. B. Altman & Company* (1933), 270 N.Y.S. 781; *Levy v. Drew*, 4 Cal.2d 456, 50 P.2d 435; 9 *Am. Jur.* 2d 405, Bankruptcy, §522;[10] 4 *Collier, Bankruptcy* (14th Ed.), §68.04[2.1], page 73.

There is indeed no dissent to this view.

Appellee contends that a trust fund or quasi-trust fund did, in fact, exist herein by virtue of the bankrupt's filing of a Notice and Claim of Lien. There is no challenge about it having been filed timely and in the proper manner. Its legal efficacy is challenged upon the sole ground that a copy of same was not

[9]"A wrongdoer who has misapplied the subject of a trust is not entitled, either under the Bankruptcy Act or under the rules of equitable set-off, to apply a credit that belongs to him in his own right in cancellation of his liability as a fiduciary."

[10]"A creditor's unauthorized possession of funds of the bankrupt can give the creditor no right to apply them in payment of his own claim to the prejudice of the rights of other creditors."

served upon the owner, which, it will be recalled, is Tucson Title Insurance Company, as Trustee. To begin with, this defense would seem to be available only to the owner. It is not a party to these proceedings. Furthermore, the primary object of A.R.S. §33-981, authorizing the filing of a laborer's or materialman's lien, is to insure to the laborer and materialman who enhanced the value of another's property the payment of their accounts, and the object of A.R.S. §33-993, requiring that a copy of the Notice and Claim of Lien be served upon the owner, is to protect the owner from double payment, i.e., from first paying off the contractor and "later find his property plastered with liens of laborers and materialmen whose accounts had been left unpaid." *Arizona E. R. R. Co. v. Globe Hardware Co.* (1913), 14 Ariz. 397, 400, 129 P. 1104. These statutes, the Arizona Supreme Court has held, are remedial and should therefore be liberally construed in favor of the laborer and materialman. *Leeson v. Bartol* (1940), 55 Ariz. 160, 99 P.2d 485. Here the latter object was unquestionably met, inasmuch as the owner learned of the existence of the lien before final settlement. Moreover, McKee knew of its existence all along, for it asked Fike to file same. In fact, the owner was so cognizant of its existence that it insisted upon a Lien Release Bond as a condition of releasing the retention proceeds. Such a bond was filed, and consequently the proceeds here in issue were released to Tucson House Construction Company. The mere obtaining of the proceeds under these circumstances, appellee submits, was wrongful, because, as was said in *U.S. v. Durham*

Lumber Company (1958), 4 Cir., 257 F.2d 570, 573, aff. 363 U.S. 522, 80 S.Ct. 1282, 4 L.Ed. 1371, under the North Carolina lien statutes:

> "The obligation of the owner to the subcontractor [after he filed a lien] is, thus, primary: his obligation to the general contractor, secondary."

To the same effect, See *Green v. H. E. Butt Foundation* (1954), 5 Cir., 217 F.2d 553.

To add insult to injury, Tucson House Construction Company later turned over to McKee the sum of $50,745.12, so as to permit the latter to use same for purposes other than paying Fike.

Certainly, under these circumstances, McKee had no right to acquire possession of these proceeds, let alone offset an unrelated claim, not even belonging to it, against same.

II. RELIANCE HAD NO RIGHT TO COMPEL McKEE TO OFFSET.

As has already been shown, McKee had no right to effect the attempted setoff for want of mutual debts. If McKee itself could not effect a setoff, then *a fortiori* Reliance, as subrogee to the rights of McKee, could not have compelled it to do so. It is certainly the settled law that one cannot acquire by subrogation what another, whose rights he claims, did not have. *United States v. Munsey Trust Co.* (1947), 332 U.S. 234, 91 L.Ed. 2022, 67 S.Ct. 1599.

Moreover, even if McKee had a right to effect the attempted setoff in its own right, Reliance could not have availed itself of that right, for a surety is subrogated only to those rights of the obligee against the

principal which stem from the contract for which the surety is bound. In other words, here Reliance was entitled to be subrogated to McKee's rights stemming out of the Lincoln Hospital Subcontract with Fike. Reliance was, in fact, so subrogated, for it collected Fike's unpaid progress payments and the retention proceeds which McKee had withheld from Fike under the said Subcontract. That is, however, where Reliance's right of subrogation must stop. As is said in 83 *C.J.S.* 681, Subrogation, §52:

> "Furthermore, *a surety will be subrogated only to such rights* and securities *as are held by the creditor with respect to the particular debt or contract for which the surety is bound.*" (Emphasis supplied.)

Supporting this statement are three cases, namely, *U. S. F. & G. Co. v. First National Bank of Lincoln* (1932), 224 Ala. 375, 140 So. 755; *American Surety Co. of New York v. Town of Islip* (1944), 48 N.Y.S. 2d 749; and *Fidelity & Casualty Co. v. Copenhaver Contracting Co.* (1932), 159 Va. 126, 165 S.E. 528. The last case is particularly in point, for it held that a surety of a defaulted contractor has no right to claim funds due to the defaulted contractor under another contract.

Yet, it will be remembered that *subrogation* is the *sole* basis upon which Reliance ostensibly "compelled" McKee to effect the attempted setoff. Said Reliance (Mr. Haug) to McKee (Mr. Haug):

> ". . . Reliance claims this right to require this offset by virtue of its right of subrogation to the

rights of McKee arising out of the relation of principal and surety under law and equity." (Trustee's Exhibit 10.)

Appellants now argue vociferously that "Reliance had a legal right under A.R.S. Sec. 12-1641 . . . to compel McKee to proceed against Fike by exercising its right of setoff." While this is charitable on the part of McKee towards Reliance, it is devoid of any merit.

But for the provisions of A.R.S. §12-1641, appellants would admit that upon Fike's default Reliance had no right to compel McKee, as obligee, to proceed against Fike, as principal, in any manner whatsoever. An excellent statement of the rule, and of the reason for it, is found in *Simpson on Suretyship*, §42, page 173, to wit:

> "*As a general rule, the surety has no right against the creditor to compel the latter to attempt collection of the debt from the principal.* Mere passiveness or lack of diligence on the creditor's part has no effect upon his right against the surety. *It is for the surety to pay or see that his principal pays. One of the creditor's purposes in demanding the security of the surety's promise is to avoid the burden and delay incident to enforced collection.* This consideration justifies the decisions that the surety is not discharged because the creditor fails to proceed against the principal until his remedy is barred by the statute of limitations. It likewise justifies the general rule that the creditor's failure to realize upon security is no defense to the surety." (Emphasis supplied.)

Assuming that this statute is applicable herein, has Reliance complied with the provisions thereof so as to remove the instant case from the common law rule? Appellee thinks not, particularly in view of the fact that under the accepted rules of statutory construction, all statutes in derogation of the common law must be strictly construed. *Richardson v. Ainsa* (1908), 11 Ariz. 359, 95 P. 103, aff. 31 S.Ct. 23, 218 U.S. 289, 54 L.Ed. 1044.

The statute provides, in part, that a "surety upon a contract for payment of money or performance of an act . . . *may require, by notice in writing, the* creditor or *obligee forthwith to bring an action upon the contract.*" There is absolutely nothing in the record before this Court to indicate that a "notice in writing" was given by Reliance to McKee requiring the latter "forthwith to bring an action upon the contract." In order to render the provisions thereof operative, proof of such notice is obviously essential. In fact, in Indiana, under a statute identical to the one here in issue, it was held that the proof of notice must be in the same manner and form as is provided by statute for serving other legal notices. *McCoy v. Lockwood* (1880), 71 Ind. 319. Moreover, the notice, which has to be in writing, must unconditionally require suit to be brought forthwith. The mere leaving out of the word "forthwith" was held to be defective notice in two Indiana decisions, namely, *McMillin v. Deardorf* (1897), 18 Ind.App. 428, 48 N.E. 233; *Frye v. Eisenbiess* (1914), 56 Ind.App. 123, 104 N.E. 995. In contrast, here no notice of any kind was given.

There are at least two additional reasons why A.R.S. §12-1641 is not applicable herein.

First, it is to be noted that the statute may be rendered operative only when the obligee is not under "legal disability" to bring an action upon the contract against the principal. Here McKee was indeed under a "legal disability" to bring an action against Fike, for one may not sue a bankruptcy trustee, who succeeds to all the rights of a bankrupt after his adjudication, without permission of the Bankruptcy Court. 1 *Collier, Bankruptcy* (14th Ed.), §2.36[1]. No such consent was sought or obtained by McKee.

Secondly, if one pauses to reflect, it becomes evident that the object of the so-called *Pain v. Packard* doctrine—not a favorite of the law—and the provisions of A.R.S. §12-1641 which permit a surety to require his obligee to bring an action upon the contract against the principal as soon as the obligation becomes due is to minimize the risk that thereafter the principal might become insolvent and thus render the obligation, which was previously collectible, uncollectible. But once the principal is already insolvent, as in the case at bar, it seems foolish to permit a surety to require an obligee to go through an idle and fruitless ceremony. Since the law does not require futile things, it is fair to conclude that the provisions of this statute have no application herein.

It is, thus, clear beyond legitimate doubt that Reliance had no right to compel McKee to use Fike's proceeds from a wholly unrelated job to satisfy the claims of Fike's suppliers on the Lincoln Hospital

Job which Reliance was legally obligated to pay under its surety contract.

III. INTEREST AND ATTORNEY'S FEES.

The lower Court, after having found that the retention proceeds here in issue were due and payable to the bankrupt on January 11, 1965—thirty days after receipt of final payment from the Owner—awarded the bankruptcy trustee interest on such proceeds as of that date. All authorities agree that interest on a liquidated sum is a proper item of damages in favor of the person who was deprived of the use of such proceeds. The Arizona Supreme Court, in approving this rule, said:

> "It is settled law in this jurisdiction that a creditor is entitled to interest on money withheld after due as damages for the loss of its use . . . [and it is] the duty of the Court to add it to the judgment."
>
> *Southwest Mines Development Co. v. Martignene* (1937), 49 Ariz. 88, 92, 64 P.2d 1031.

To the same effect, see 22 *Am. Jur.* 2d, Damages, Section 180.

The appellants argue that they were entitled to keep the proceeds here in issue during the life of Fike's warranty on the Tucson House Job, which they claim commenced on December 11, 1964, and ended on December 11, 1965. Firstly, they had no right to do this, for the contract between them admittedly does not so provide. Secondly, they had the assurance of

National Insurance Company, Fike's surety, on that job, which covered Fike's warranty as well.

Moreover, subsequent events have shown that but a fraction of these proceeds were used on warranty items on the Tucson House Job. Consequently, if appellee's position is sustained, it is only fair that appellants be required to pay interest on these proceeds for the duration that they withheld same from him. This places no hardship and results in no inequity to appellants, for they had the use of these proceeds or could have placed same into interest-bearing deposits or securities and thereby earn all or substantially all of the interest which is charged against them by the Court's award.

As to attorney's fees, appellants complain that the Bankruptcy Court had no jurisdiction to award such fees to begin with, and if it did, the award was improper for lack of evidence. On the first point they offer no supporting authorities whatsoever, and on the other point they offer inapplicable State authorities.

Section 2(a)18 of the Bankruptcy Act expressly authorizes Courts of Bankruptcy to tax costs. The Federal Rules of Civil Procedure, when not inconsistent with the Act, apply in bankruptcy proceedings as well. General Orders in Bankruptcy, General Order 37. Under Rule 54(d), Federal Rules of Civil Procedure, attorney's fees, when provided for by contract, may be taxed as an element of costs. 1 *Collier, Bankruptcy* (14th Ed.), §2.71; 6 *Moore's Federal Practice* (2nd Ed.), §54.77[2]. This is true under Arizona law.

Commercial Standard Insurance Co. v. Cleveland (1959), 86 Ariz. 288, 345 P.2d 210. Here such fees were, of course, provided for by contract.

The term "Court" is defined in Section 1(9) of the Act so as to include proceedings before a Referee as well. Hence, the awarding of attorney's fees is clearly a proper exercise of a Referee's jurisdiction. *In re Swofford* (1952), 112 F.Supp. 893 (D.C. Minn.).

As to the amount of the fee and the manner of proving same, all authorities agree that these are matters which are left to the sound discretion of the trial Court. Since neither the quantum of the fee nor the manner of proving same involves State substantive law, the Federal Court is not bound to follow State procedures with respect thereto. In Federal courts no evidence is required as to the quantum of the fee when the fee is set by the trial judge who heard the case. Indeed, this makes good sense, for he is in the best position to judge the true value of the services of the attorney appearing before him. 7 *Am. Jur.* 2d 197, Attorneys at law, §269.

A bankruptcy case in point is *Campbell v. Green* (1940), 5 Cir., 112 F.2d 143, 144. Another case in point is *Curran v. Security Insurance Company* (1961), 195 F.Supp. 562 (D.C. Ark.) In the latter case, neither party offered any testimony as to the reasonable value of the fee. In making the award, nevertheless, the District Court reasoned, to wit:

> "In view of the conclusion that the court has reached, the plaintiff is entitled to recover a reasonable attorney's fee, and the court, even in the

> absence of testimony as to the amount of such fee, may fix the same based upon the record before it." 195 F.Supp. 562, 570.

This is precisely what the Referee did. And the District Court concurred.

CONCLUSION

Based upon the foregoing authorities, it is evident that the Order of the Referee, already affirmed by the District Court, is in all respects just and proper and therefore should be affirmed.

Dated, Phoenix, Arizona,
October 3, 1966.

Respectfully submitted,
Henry Jacobowitz,
Attorney for Appellee.

Certificate of Counsel

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Henry Jacobowitz,
Attorney for Appellee.